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OCTAVIA's OUTLOOK
VOLUME 1: FALL 2014

The objective of this letter is to explain recent market performance and share my views on the direction of markets going forward. In summary:

1. The selloff in global assets over the past month (through October 17) resulted from hedge fund liquidations, be it unwinding of short positions in US long term treasuries, long positions in European equities and sovereign debt, long positions in WTI oil, long positions in high beta US equities, etc. And, the unwinding of these positions led to further selling across all positions. This is what happened in 2008, but at a much, much larger scale.
2. Ebola and economic data don't matter and earnings announcements matter for about one day, maybe.
3. The direction of all asset classes going forward depends on (1) central bank policies as it relates to quantitative easing programs and (2) central bank interest rate policies as it relates to currencies and depending on the magnitude of any rate increases to equity markets. As goes central bank policies, so go the markets.
4. Through the end of 2014, I do not believe that markets will price securities assuming the Fed will start a new QE program nor do I believe that the ECB will implement QE. As a result, I am planning to overweight fixed income and underweight equities.

Where Are We Now?

"The S&P 500's streak of weekly losses was it's longest since August 2011, and the index still is off 6.2 percent from its Sept. 18 record high. The drop follows worries over the health of the global economy, the spread of the Ebola virus, as well as factors including lower oil prices and uncertainty about the Federal Reserve's next steps." This came from a Vanguard daily summary report on Friday, October 17th and is representative of what most market pundits were saying. I completely disagree with the consensus view.

The biggest lesson I learned in 2008-2009 was that liquidity supersedes fundamentals. Strong companies with growing businesses can see their share prices fall simply because there are more sellers than buyers. And, the selling can be for reasons that have nothing to do with the companies.

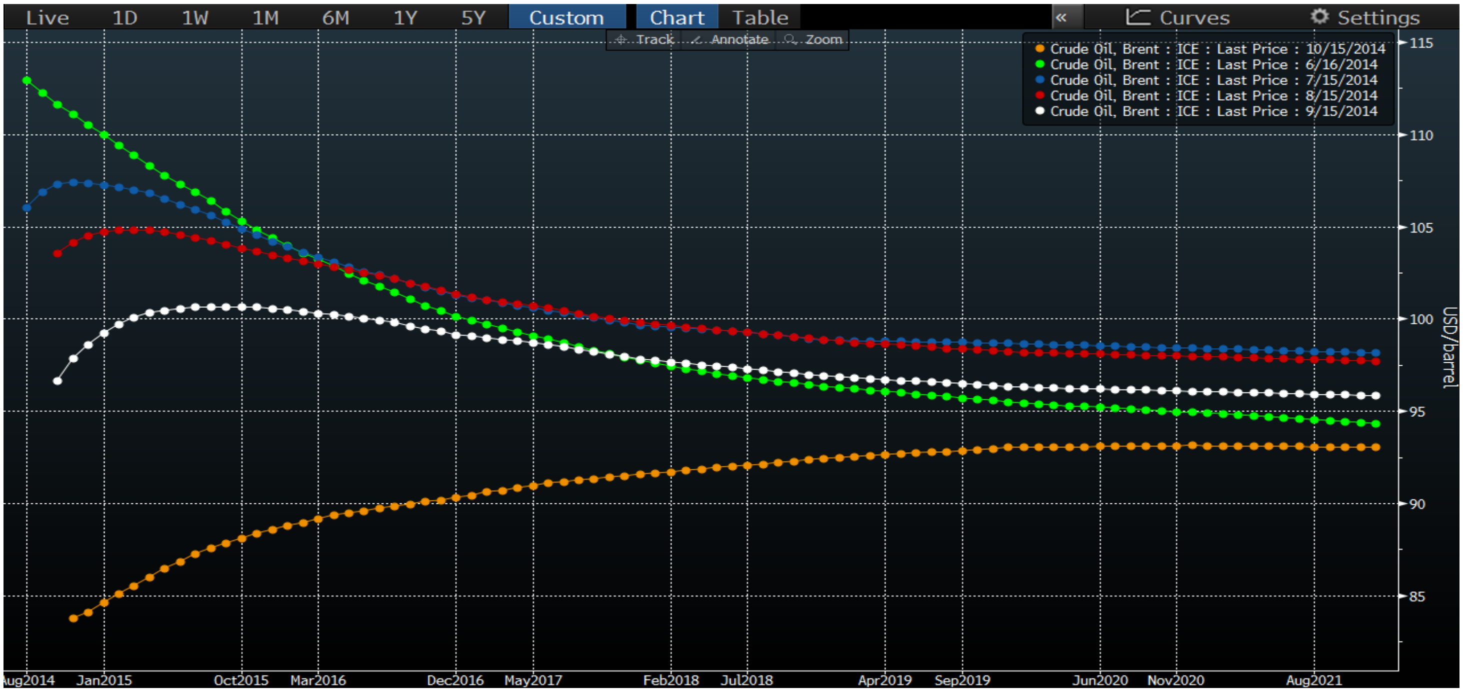
I do not have actual evidence to support my views because such data is not in any databases, so I recognize this is pure conjecture. But, I believe the sell-off from the market peak on September 18th is the result of hedge fund liquidations. And, the hedge fund liquidations occurred for four reasons.

First, investors in hedge funds are questioning the value of paying high fees to hedge funds when, in the aggregate, hedge funds over the past five years have consistently underperformed the market. I do not want to debate whether investors are making the correct decision, since it does not matter. What matters is that investors are putting in redemption notices, and this forces hedge funds to liquidate positions. And, perversely, often the positions that get sold are the ones that can be liquidated with the lowest impact on the price of the security. Thus, good companies get sold off.

Take a look at the above chart. It shows the performance of the S&P 500 in 2014 through October 17th. There have been four sell-offs: late January, early April, late July and late September-early October. Each one occurs around the end of the prior quarter. I believe this corresponds with hedge funds selling positions to satisfy investor redemptions.

Hedge fund redemptions are not sufficient, though, to fully cause market sell-offs, but they can be the trigger. What follows are the three additional factors causing hedge fund liquidations. First, there are stop losses. Hedge funds often congregate into many of the same trades. Once some hedge funds start selling positions, then the downward pressure in the security can trigger stop loss selling by other hedge funds, which then feeds on itself. Next thing you know, the security is down 30%. I think that American Airlines is a perfect example of this. American Airlines is a crowded trade held by many hedge funds. On June 23rd, AA hit $44.88, its 52-week high. By October 13th, AA was down 37.4% at it low price of the day. AA is not some fly by night speculative company. It has a roughly $25 billion market valuation. And, at its low on October 13th, AA traded at 4x its 2015 estimated earnings, when United and Delta traded at roughly 7x. AA suffered from hedge fund liquidations. Yes, there is the potential that Ebola will hurt travel, but there are no signs yet of this happening. Yes, a global economic slowdown will hurt AA disproportionately given it dependence on Latin American and European routes, but that has been the case for months. And, with jet fuel at 1/3 of airline expenses, the 25% decline in crude prices is a boon to airlines profitability. No, this is hedge funds dumping positions.

The next factor is margin calls. Hedge funds use leverage to increase returns. But, if positions decline enough in price, the leverage providers can force the hedge funds to sell positions. The best example of this is what happened in crude oil trading. On October 14th, in the span of a few hours at the end of the trading session, crude oil fell $4, which is 5%. That is like the Dow Jones falling 1,000 points in a few hours! This was hedge fund margin calls. Many hedge funds were betting on oil prices going up, yet the price had fallen from about $112 in June to under $81. Hedge funds were being forced to close their positions.



Also, please look at the above chart. While near dated oil prices fell from $112 to $80, long dated prices fell less than $10. Granted, long dated contracts are not very liquid but when oil prices go from backwardation (near term price higher than future price) to contango (near term price lower than future price), that tells you the change in price is about near term factors not long term factors.

The last factor is simple preservation. Many hedge funds had incurred sufficient losses in September and October that they were approaching going negative for the year. They decided to dump their positions and prevent going negative for the year. Again, forced liquidations of positions when there were not sufficient buyers to handle the volume of selling.

Finally, if you look at where the most carnage has been, it's all of the trades where hedge funds crowded together. Hedge funds were long airlines, long shale oil E&Ps, short long term US treasuries, long low grade European sovereign debt, etc. And, these are the areas that have experienced the biggest declines relative to the market. On Wednesday, October 15th the US 30 year treasury bond within minutes of opening was yielding 2.68%, versus 2.96% the day before. This resulted in about a 10% increase in the price of bonds. And the US 10 year treasury note was even more volatile, with the yield decreasing from 2.21% to 1.87%, a 34 basis point move. 10% price moves in something as liquid and typically stable as the US 30 year just do not occur unless there is a major exogenous event, such as a massive unwind of a position. By the end of the day, the yields on the 30-year were back to 2.09% and as of October 17th were 2.20%. The forced liquidation, for now, appears to have ended.

Before we move on to where markets are going, a quick thought on 2014 to date. 2014 has been an interesting year in the US equity and fixed income markets. The consensus entering the year was that interest rates would go up, but in fact they have fallen. The other consensus was that it made no sense to buy long-term treasuries that only yielded 4%. If you had purchased long-term US treasuries (via EDV) on December 31st, you would have realized a total return of 34.2% as of October 17th. Please do not confuse income yields with total returns. If you forecast the direction of interest rates correctly, you can make large returns using long dated bonds. In US equity markets, it's a story of haves and have not's. At September 30th, the S&P 500 was up 8.2% (via SPY), yet the Russell 2000 was down 4.3% (via IWM). The "haves" are made up of mega caps such as Apple, Microsoft, Intel, Gilead, Facebook and the like. The "have not's" are hundreds of small and mid cap companies. And, since the indices are market cap weighted, the mega-caps have a disproportionate impact on indices. In reality, outside of a limited group of companies, stock performance in the US broadly speaking has been poor so far this year. But, the indices such as the S&P 500 or even the NASDAQ hide this fact.

Where Are We Going From Here?

The recent market turmoil has been driven by hedge fund liquidations, but as soon as the selling stops the market volatility should subside. I believe that the liquidations reached their peak on Wednesday, October 15th. Over the next few weeks, equity markets will trade sideways but that the deeply beaten securities will begin to recover their losses. Once earnings season largely ends in late October, companies will continue with share buybacks, providing a boost to stock prices and the indices (more on this below). But, looking to November and December and further into 2015, I believe the direction for all securities (equities, fixed income, commodities) will depend on the direction of central bank monetary policies. And, specifically, for US equities to rally in 2015 will require another round of QE. Without QE, US equities will decline in 2015. Likewise, if the Fed does not embark on another round of QE, my forecast during 2015 for US 10 year and 30 year treasury yields is 1.25% and 2.0%, respectively, and thus they should be purchased in such a scenario. Therefore, markets must be closely watched for signs of what the Fed plans to do in 2015.

In forming my conclusions, what follows are the factors I am considering.

1. Deflation in asset prices due to the unwinding of a 30-plus year debt boom

The global economy, and especially the US, has been growing for the past 30-plus years through debt-fueled consumption. As an individual, if you want to buy more, you have three choices. One, you use your savings. Assuming you have no available savings, then you can work more or smarter in order to generate more income and thus be able to consume more. Or, finally, you can borrow the money to consume more. The US, in the aggregate, has chosen option three (I will focus on the US but my conclusions are relevant for most economies throughout the developed and developing world).

Instead of people being more productive to generate more income to fund growing consumption, they have borrowed more in order to grow their consumption. And, this growth in consumption is what has propelled growth in nominal GDP. To me, real GDP growth is increased productivity of the citizenry, leading to growing income and then resulting in growing consumption (and from an economic standpoint a real increase in standard of living). Instead, the US has (1) relaxed lending standards (via financial institutions in conjunction with Congress and regulators) in order to offer increasing levels of debt and (2) cut interest rates (via the Federal Reserve) to make it easier to service this growing debt balance. And, this increased debt is what has increased consumption and thus increased GDP. The increase in debt and thus spending has occurred both at the individual level and at the governmental level.

Free economies trend to find equilibrium in the volume of goods offered and the price for such goods; it's all about supply and demand. And, back in 2008 (as well as today) the economy was way out of equilibrium. In a world without debt, consumption would equal income plus or minus savings (i.e., contributing to savings or using savings). You could only buy something if you have the cash; there is no credit. In the world of the past 30 years culminating in the financial crisis of 2008, consumption was a function of income and credit. But, incomes had not been growing. In fact, real median incomes today are not much different than 15 years ago. Increasing amounts of debt at lower interest rates were the only way to keep nominal GDP growing year after year.

2008 was the bursting of the debt bubble. Increasing levels of less expensive debt had enabled asset prices to become disconnected from underlying economics. **Income and savings were not (and still are not) sufficient to support the level of asset prices**. I highlight the prior sentence because it is critical to understanding why we are in midst of secular deflation. If financial institutions withdraw access to credit, as they have done since 2008, then asset prices should fall. The supply of assets has not decreased. And, incomes are not rising. And, credit is being withdrawn. Thus, asset prices should fall. And, yet, the opposite has happened. Stock prices are up 200% from March 2009. Home prices are up substantially across the US. Why? The reason is the Federal Reserve's Quantitative Easing program and zero interest rate policy. While the private sector was withdrawing credit from the economy, the Fed was making it available by, in effect, creating money. The Fed created about $4 trillion in credit to enter the economy. Yet, the economy still wants to find equilibrium in real terms. And, thus, after the conclusion of each of the Fed's QE programs, when the influx of money was terminated, asset prices returned to their trend of declining. After QE1, the S&P 500 fell about 15%, but turned around with announcement of QE2. Then, after the end of QE2 the S&P 500 again fell about 15%, but turned around with, you guessed it, the announcement of QE3. Assets want to find a price where income levels (and some appropriate level of debt) can support them. **Without artificial stimulus from government intervention, such as QE programs and low interest rates, current asset prices are way too high relative to income levels**.

QE also has the affect of devaluing a nation's currency. By creating money, a nation's central bank is diluting the value of the existing currency in circulation. The more money a central bank creates, the less the existing money is worth. This is why the US dollar has been so weak against the Euro until a few months ago and against the yen until a year ago. What changed? The Bank of Japan embarked on their own QE and the ECB hinted that they would begin QE, thus neutralizing the impact of US QE on the relative valuations of the currencies. With the Fed phasing out QE3 during 2014 (it ends in October 2014), the dollar has been rallying against the Euro and Yen.

2. China is a Threat to the Global Economy

Over the past several years, China's growth has been fueled by debt-financed production without sufficient demand for the inventory being produced. China looks like the US before the real estate induced financial crisis in 2008. Given that China makes up about 1/3 of global growth in GDP, a slowdown in China will be a huge drag on global economic growth.

3. US GDP growth has disconnected from corporate earnings

Pundits in the financial media repeatedly state that economic growth is doing such and such and therefore stocks will do such and such. I believe this way of thinking is antiquated and does not reflect current circumstances. Simply put, US GDP growth has disconnected from corporate earnings. There are two key factors that have led to this. First, in a world where US corporations' sales are mostly within the US, changes in GDP are highly correlated to changes in US corporate sales and earnings. But, today nearly half of S&P 500 companies' sales are outside of the US. So, when the US has strong GDP growth relative to the rest of the world, this does not necessarily translate into sales and earnings growth.

The second, and more critical, factor is that the number one contributor to earnings growth over the past several years has been corporate share buybacks, not changes in sales and operating profits. In a world of central bank induced low short-term interest rates, there is no benefit to keeping cash on a corporate balance sheet since the corporation earns nothing on the cash. Instead, corporations are incented to return the cash to shareholders via dividends and/or share buy-backs. Share buy-backs are more advantageous to company management since management receives a material amount of compensation via stock options, and share buybacks increase the value of the shares where dividends do not. And, thus, corporations have been buying back their shares to reduce the share count and grow EPS (even if net income does not change, by using cash to buy back shares and reduce the number of shares in the denominator, a company creates EPS growth; since cash earns zero, the use of the cash has no impact on interest income and thus no negative impact on net income).

Quoting from a June 29, 2014 Wall Street Journal article "Mr. Kleintop of LPL Financial and Scott Clemons, chief investment strategist at Brown Brothers Harriman Private Banking, both calculate that half of the first quarter's S&P 500 per-share earnings gains came from declining share count, not from increases in actual earnings." Stop and think about that. Half of S&P 500 earnings growth is from a reduced share count, not increasing net income. And, don't forget that lower interest rates make debt less expensive and thus reduce interest expense, another benefit to EPS growth. What this all means is that EPS growth has been driven by the Federal Reserve's zero interest rate policy. Zero short-term interest rates on cash means there is no benefit to holding the cash, versus using the cash to buy back shares and reduce the share count, thus increasing EPS. And, low interest rates also enable corporations to raise debt at 1.5% to 2.5% after-tax interest rates and buy back shares with earnings yields of about 7% (the inverse of a 15x PE multiple). Corporations are arbitraging these relative costs to create EPS growth.

4. Falling oil prices are bad for the US economy

The financial pundits all say the same thing, "falling oil prices is a boon to the US consumer and will benefit the US economy." I completely disagree. For every $1 drop in gas prices, consumers save $100 billion. But, if oil prices fall enough such that US shale drilling is curtailed, the impact on lost jobs will trump the savings at the pump by orders of magnitude. Its not just the companies drilling for the oil, it's also the pipeline companies that move the oil, the steel companies and industrial equipment companies needed to build the pipelines. And, don't forget about the service companies that service the people employed by companies involved in the shale drilling areas. The states with the strongest economic growth are the states with shale drilling. Take away shale drilling and the US economy will go into recession.

5. The ECB is looking like it will not implement its own QE program

During the summer, European Central Bank president Mario Draghi gave the markets the impression that an ECB QE was coming. But, in the past few weeks he has pulled back from such indications. And, German Bundesbank president Jens Weidmann said the following on October 17th "The biggest bottleneck for growth in the euro area is not monetary policy, nor is it the lack of fiscal stimulus: it is the structural barriers that impede competition, innovation and productivity". While the Germans may change their tune, it looks now like ECB QE is off the table. The Euro has been rallying against the US dollar on this change in tone after a material sell-off following Draghi's earlier comments.

Global markets have benefitted from US, Bank of England and Bank of Japan QE programs. But, with the US ending its QE program, markets were counting on the ECB to begin a QE program and pick up from where the US was leaving off. It now looks like that is less likely.

6. US Treasury rates are anchored by European sovereign rates

Europe has little to no grow, and European banks have little interest in making loans. But, the ECB charges them 15 basis points to deposit money with the ECB. So, what is a European bank to do with deposits they don't want to lend but that cost money to store with the ECB? Buy sovereign debt, which is deemed "risk free" and thus does not require reserves be held against the positions. This and the real concern about deflation in Europe are why rates on European sovereign debt are so low. Until recently when hedge funds unwound their positions, the rates on Italian and Spanish debt were lower than on US debt. That is crazy given the credit profile of the US versus Italy and Spain. And, Germany's 10-year debt yields 0.8% versus 2.2% for US 10 year debt. And, while we are at it, Japanese 10 year debt yields 0.5%. As long as rates are so low in Europe, they will act as an anchor on US rates. European banks will buy US treasuries for the higher yields and US dollar exposure. Ironically, an ECB QE program would be horrible for 10 and 30 year US treasuries because QE would be inflationary and push up European sovereign rates, dragging up US rates in the process. I know what you are thinking. Doesn't Octavia know that QE potentially involves buying government debt and thus driving prices up and yields down? But, if you look at the actual results, you come to the opposite conclusion. During the Fed's three QE programs and the two gaps between QEs, long-term treasury rates increased during all three QEs and fell in-between the programs. This is because QE is, by definition, inflationary and inflation reduces the value of long-term debt.

7. Fed monetary and interest rate policies impact the value of the US dollar

S&P 500 companies derive an increasing amount of sales internationally. To the extent those sales are denominated in the local currency, and to the extent that Fed policy leads to a higher US dollar, S&P 500 companies will face a drag on revenues and earnings when translated from the local currency back to US dollars.

8. The Fed understands that low interest rates help the US federal government finance its debt

One final thought before I discuss specific implications on security selection. The US federal government has about $11 trillion in external debt (debt no owed to itself). A 1% increase in interest rates (across all maturities) would thus result in a $110 billion increase in interest expense for the federal government. In addition about 65% of this debt matures in the next 3 years and thus will be replaced with new debt issued at the then current interest rates. If the Fed materially increased short-term interest rates, it will create a huge financial burden for the federal government. The Fed is fully aware of this point, which will impact their decisions as it relates to raising interest rates in the future.

OK, So Now What?

There are four possible scenarios related to Fed and ECB QE. In each, I lay out some broad investment strategies. Of course, there are numerous factors to consider, including the price of oil and what that means for the US economy. But, as it relates to QE policy and ignoring everything else, this is how I would invest in the four scenarios:

Neither Fed nor ECB implement QE

1. Buy high credit quality, longer duration US debt
2. If the Fed also does not increase short-term interest rates, buy levered closed end bond funds
3. If the Fed does increase short-term interest rates, short US regional banks. Without QE and with rising short-term rates, the yield curve will flatten, crushing US regional bank earnings

Fed does not implement QE, but ECB does

1. Short the Euro versus the US dollar
2. Buy European equities
3. If the Fed does increase short-term interest rates, short US regional banks. Without QE and with rising short-term rates, the yield curve will flatten, crushing US regional bank earnings
4. If the Fed also does not increase short-term interest rates, buy levered closed end bond funds

Fed does implement QE, but ECB does not

1. Buy US and emerging markets equities
2. Short the US dollar versus the Euro

Fed and ECB both implement QE

1. Buy US, European and emerging markets equities

I will be actively paying attention to central bank policy. As goes central bank policy, so go the markets. Through the end of 2014, I do not believe that markets will price securities assuming the Fed will start a new QE program nor do I believe that the ECB will implement QE. As a result, as 2014 progresses and we enter 2015, I am planning to overweight fixed income and underweight equities.

Finally, as it relates to right now, as I already mentioned I believe the hedge fund liquidation was largely completed by October 15th. In fact, I tweeted such. You can check my tweets to see what I was writing about markets in October (@andrekovensky). As a result, there are many beaten down US equities that can be purchased now for a trade, but I would expect to sell them within days or weeks. These are opportunistic trades and do not relate to my overall thesis on market direction.

Sincerely,
Octavia Investments LLC